

# Revenue Review

Tennessee Department of Revenue

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REVENUE ...  
*Working for You!*

October 2004

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Visit our Web site to subscribe to Revenue-News or lists dedicated to county clerks and city officials.

## Contact Us:

Tennessee Department of Revenue  
Attn: Taxpayer Services  
500 Deaderick Street  
Nashville, TN 37242  
(615) 253-0600  
Statewide toll-free:  
(800) 342-1003

## The Tennessee Court of Appeals Analyzes Contractors' Use Tax

The department takes many questions concerning tax obligations of contractor-dealers. A contractor-dealer is a taxpayer who sells items and who also installs or uses those items to improve real property. For example, in some situations a cabinetmaker may sell a completed cabinet to a customer who installs for himself. In other situations, the cabinetmaker may contract to install the cabinet for the customer.

The Tennessee Court of Appeals issued a decision that provides a comprehensive analysis of Tennessee's use tax as it applies to contractor-dealers. The case is *Security Fire Protection Company, Inc. v. Huddleston*, No. W2002-01175-COA-R3-CV, slip op. (Tenn. Court App. May 19, 2003) *petition for cert. denied* (Tenn. June 21, 2004). Because this is an area of the law where many taxpayers have questions, we have included a full discussion of the case below. An "in a nutshell" outline of how tax should be paid by contractor-dealers is included on p. 2.

The taxpayer, a contractor-dealer, purchased certain materials using a Tennessee resale certificate and stored them in its Memphis warehouse. The taxpayer purchased other materials outside of Tennessee and brought them into the state to store in its Memphis warehouse. The taxpayer then withdrew materials from inventory, fabricated them into component parts for fire protection systems, and installed them into real property located outside of Tennessee. The taxpayer paid tax in the states where it installed the fire protections systems. The department assessed Tennessee tax on the materials.

The taxpayer made four arguments against the assessment:

1. The taxpayer argued that it resold the fire protection systems to either the general contractor for the construction site or to the property owner before it installed them. The department argued that title to the materials did not pass until after Security Fire used them in fulfillment of its contracts.

**Holding:** The Court of Appeals concluded that the taxpayer owned the materials at issue at the time that it installed them.

**Discussion:** The factors that the Court considered in making this determination were as follows: the contract did not specify passage of title; the responsibilities incidental to ownership of the materials remained with the taxpayer; the

*continued on page 2.*

## Revenue Adds New E-filing Option: Online Filing of Franchise and Excise Estimated Payments and Extensions

On Aug. 11, the Department of Revenue added a new online application to its ever-expanding suite of electronic tax filing options: franchise and excise estimated payments and extensions filing. This online service is now available on the department's Web site, [www.Tennessee.gov/revenue](http://www.Tennessee.gov/revenue).

Any taxpayer that has an annual franchise and excise tax liability of \$5,000 or more is required to make quarterly estimated payments. In addition, if a taxpayer owes \$10,000 or more in franchise and excise tax quarterly payments, the filer is required to make payments in funds immediately available to the state on the date of payment. This online filing feature provides another filing option and also meets the immediately available funds requirement.

All franchise and excise taxpayers now can file their extension forms and payments online.

The Department of Revenue offers computer access to customers who don't have such technology, so they can file their taxes online. Computer access is available in the department's offices in Chattanooga, Jackson, Johnson City, Knoxville, Memphis and Nashville.

## Technical Questions

**Q: What is a tire pre-disposal fee, and can the fee be passed on to the customer?**

**A:** In accordance with Tenn. Code Ann. § 67-4-1601, persons making retail sales of new tires for use on motor vehicles must pay a \$1 pre-disposal fee for each new tire sold. This fee can either be paid by the retailer or passed on to the customer. If the fee is passed on to the customer, it is considered to be part of the sale price of the tires. Retailers must collect sales tax on the total sale price of all taxable items. Therefore, if the pre-disposal fee is passed on to the customer then sales tax would be due on the entire purchase price of the tires including the \$1 per tire fee.

**Q: Can a retailer charge their customers an additional handling fee to cover its cost of disposing of the used tires?**

**A:** Yes. However, retailers should make sure that they state any additional disposal fee as a separate line item on the invoice. If a retailer combines the tire pre-disposal fee and the additional handling fee as a single line item on the invoice, then the entire amount must be remitted to the state.

## The Tennessee Court of Appeals Analyzes Contractors' Use Tax, continued

taxpayer both delivered the materials to the job site and used the materials; and the taxpayer was a subcontractor.

2. The taxpayer argued that it resold the items that it had purchased in Tennessee on a resale certificate, and paid sales and/or use tax in the state where the materials were installed. The department argued that as soon as the items were withdrawn from inventory for the taxpayer's own use they became subject to Tennessee's tax.

**Holding:** The Court held that the taxpayer used the materials as a contractor under Sales and Use Tax Rule 8 when it incorporated the materials into its fire protection systems and installed them. Regardless of where the use occurred, because Security Fire used the items instead of reselling them, it was subject to sales tax on the items (sales tax that it originally avoided by issuing a resale certificate).

**Discussion:** Under Rule 8, a contractor-dealer may purchase materials on a resale certificate. After purchasing items on a resale certificate, the contractor-dealer must collect and remit sales tax on any item withdrawn from inventory and resold. Alternatively, the contractor-dealer must pay tax on any item withdrawn from inventory and used by it. The taxpayer would have had to pay Tennessee tax, but for the use of the resale certificate. Therefore, the items purchased in state were properly subject to Tennessee sales tax. The taxpayer was permitted, by operation of a state regulation, to avoid paying the sales tax only because it anticipated that some of the items would be resold as opposed to used.

Sales and Use Tax Rule 68(2), which provides that a dealer cannot use a resale certificate to purchase items for its own use, also applies. Items purchased under Rule 8 are only exempt if they are resold. The Court of Appeals clarified that "reading Rule 8 and Rule 68 together, it is clear that a contractor-dealer who uses materials in performance of his own contract is not exempt from the payment of sales tax on those materials. The tax liability on property used in the performance of a contractor-dealer's own contracts is incurred at the time of purchase as a retail sale as the sales tax would be collectable at that time but for the resale certificate." Under the Court's analysis, a contractor-dealer who purchases materials tax exempt on a resale certificate becomes liable for that tax at the point when it withdraws the item from its inventory for its own use. This is true even if the contractor-dealer's use is going to occur outside of Tennessee.

3. The taxpayer argued that the "import for export" exemption applied for the materials imported into Tennessee and subsequently exported to a contract site outside Tennessee. The department asserted that the taxpayer used the items in Tennessee when it fabricated them in preparation for out-of-state installation.

**Holding:** The Court held that the taxpayer exercised a taxable use over the materials when it fabricated them in Tennessee. At that point, the materials lost their character as articles of interstate commerce and became subject to use tax. It further found that Tenn. Code Ann. § 67-6-313 did not apply.

**Discussion:** Because the taxpayer fabricated the materials in Tennessee, it exercised control over the materials which was a taxable

use. The taxpayer did not import the materials for export, but instead imported the materials for its own use. Likewise, the Court found that the manufactured for export exemption did not apply to property that the taxpayer transported to another state for its own use in the performance of a contract. In summary, the fact that the taxpayer had purchased the items and fabricated them for its own use precluded the application of either of the "import for export" or "manufactured for export" exemptions set forth at Tenn. Code Ann. § 67-6-313 (a).

4. Security Fire argued that it was entitled to credit for tax paid in other states. The department argued that tax paid to other jurisdictions was not legally paid; therefore, no credit could be given.

**Holding:** The Court held that a subsequently incurred tax cannot relieve the taxpayer of its prior liability in Tennessee.

**Discussion:** In both of the categories of materials described above, the first taxable event occurred in Tennessee. As to items purchased in Tennessee on a resale certificate, the first instance of tax was the sale. As to the items pulled from inventory and fabricated in Tennessee, the first instance of tax was the use in Tennessee. Both the sale and the fabrication occurred prior to the installation of the materials in another state. Consequently, the taxpayer's payment of tax in another jurisdiction was not appropriate in either situation. The Court refused to give credit to a tax that was not legally paid to another jurisdiction.

### IN A NUTSHELL:

#### Compliance Information for Contractor-Dealers

- ▶ If you purchase materials tax exempt on a resale certificate, you become liable for Tennessee tax at the point when you withdraw the item from inventory for your own use.
- ▶ For your own "use" means the exercise of any type of ownership over the item, whether you install the item as is, or fabricate the item into a new item.
- ▶ It does not matter whether you intend to install the item in Tennessee or in another state. If the item is withdrawn from inventory in Tennessee for your use, you owe Tennessee tax. Other states should give you credit for Tennessee tax because Tennessee had the first right to tax that transaction.
- ▶ If you bring an item into Tennessee, withdraw it from your inventory, and "use" the item in any way other than repackaging or testing the item, you owe Tennessee tax. The "import for export" exemption in Tennessee sales tax law DOES NOT apply where you exercise any use, other than repackaging or testing, over an item that you subsequently export. The "manufactured for export" exemption in Tennessee sales tax law DOES NOT apply where you withdraw items for inventory for your own use - you owe use tax on the cost price of the materials.

More information on the tax obligations of contractors and contractor-dealers may be found using the search engine on our Web site at [www.Tennessee.gov/revenue](http://www.Tennessee.gov/revenue).

## Frequently Asked Sales and Use Tax Questions

### Why does a catalog company or an online seller located in another state charge Tennessee sales or use tax?

If an out-of-state business, such as a catalog company, has a physical presence, or nexus, in Tennessee (a business, warehouse, sales representative or agency relationship), then that business is required to register to collect sales or use tax on merchandise delivered to a Tennessee customer.

If the out-of-state business does not have nexus in Tennessee, the business is not required to collect Tennessee taxes.

**Many Tennessee businesses and consumers are unaware that use tax is owed on items they have imported into this state without paying sales tax to the seller.** The use tax has been in effect since 1947 and is the counterpart to the sales tax. When someone buys merchandise online or through a catalog and the seller of the merchandise does not collect sales tax, the consumer who bought the item has a legal obligation to file and pay use tax on the merchandise. The use tax is levied at the same rate as the sales tax.

Some businesses located in other states voluntarily register to collect Tennessee sales or use tax to eliminate the customer's obligation to file a consumer use tax return. Consumer use tax returns are available on the department's Web site, [www.Tennessee.gov/revenue](http://www.Tennessee.gov/revenue).

### Should a Tennessee dealer selling merchandise through the Internet collect sales tax?

When a Tennessee dealer accepts an order through the Internet and delivers a product to a Tennessee customer, the charge is subject to sales or use tax. If the Tennessee dealer delivers a product to a consumer located in another state, the sale is not subject to Tennessee sales or use tax.

### What is a "single article," and how is sales tax on a single article calculated?

A single article is defined as one pre-assembled, self-contained item of tangible personal property in the form that it is delivered from the seller. The 7% state tax applies to the entire purchase price of the item. The applicable local sales tax rate applies only to the first \$1,600 of the sale a single article. There is an additional state tax of 2.75% applied to the amount from \$1,601 up to \$3,200 of the single article sale.

## Frequently Asked Franchise/Excise Tax Questions

### Do I have to file a franchise and excise tax return when my company did not have any activity during the year?

Yes, the minimum franchise tax of \$100 is payable if you are chartered through the Secretary of State to do business in Tennessee, regardless of whether the company is active or inactive. The minimum tax is due even if your charter or qualification has been forfeited, revoked or suspended without being properly dissolved, surrendered, withdrawn or otherwise properly terminated.

### How long can a loss be used to offset income?

Qualified net operating losses may be carried forward and deducted in the next succeeding tax year or years in which the taxpayer has net income until fully utilized, but no more than 15 years.



**You may owe gift tax if you:**

- Quitclaim property to someone, such as a child
- Transfer property to someone for less than the fair market value

Questions? Need more information? Call (615) 532-6438.

## July Collections

July 2004 collections of the Tennessee Department of Revenue were \$712,318,729, an increase of \$12,186,222 or 1.7% over July 2003 collections. Sales and use tax collections were \$507,362,578, up \$20,311,957 or 4.2% over July 2003 collections. Consumer use tax collections were up 21.9% over collections in July 2003. Franchise and excise tax collections were \$32,556,871, down \$19,684,676 or 37.7% when compared to July 2003 collections. Inheritance, gift and estate tax collections were \$8,464,411, increasing \$5,219,042 or 160.8% over last year's collections.

## Online Sales Tax Filing Statistics

Month	Number of Returns	Total of Amount Collected
June 2004	9,444	\$100,100,670
July 2004	10,133	\$107,747,918

### Did You Know ...

Revenue's Local Government Hot Line is now available by calling (866) 562-2549?

### Save the Date: Upcoming Seminars and New Business Workshops Across the State

Visit our Web site, [www.Tennessee.gov/revenue](http://www.Tennessee.gov/revenue), and click on "Seminars, New Business Workshops and Speakers" to learn more about these and other upcoming seminars and workshops.

#### November

**Nov. 4** – 2004 Business Tax Update (Tennessee Chamber of Commerce & Industry), Millennium Maxwell House Hotel, Nashville

**Nov. 10** – New Business Workshop, Chattanooga

**Nov. 10** – New Business Workshop, Johnson City

**Nov. 16** – New Business Workshop, Nashville

**Nov. 17** – New Business Workshop, Knoxville

**Nov. 18** – New Business Workshop, Memphis

**Nov. 30** – 2004 Business Tax Seminar (Association of Government Accountants), Willis Conference Center, Nashville

#### December

**Dec. 2** – 2004 Business Tax Seminar (Association of Government Accountants), Holiday Inn at the University of Memphis, Memphis

## A Note From Commissioner Loren L. Chumley



When I became commissioner, I set three primary focus areas for our department: Education, Electronic Tax Administration and Quality Control. Our tax laws have many complex provisions, and it is our job to help explain those provisions to our customers. If we educate taxpayers on the front end, then we will have fewer compliance problems later on. The second area, electronic tax administration, is beneficial for both our business customers and the department. Taxpayers can access forms, information, or Web-filing applications 24/7, and it saves the state money. Finally, quality control is critical for the success of any organization. It is not just about fixing a problem, but rather, researching why the mistake happened: Is our tax form confusing? Did the taxpayer make an error, or did we make an error?

I was pleased with some of our statistics for the past fiscal year which ended June 30, 2004. In the area of education, we hosted or presented 110 educational seminars and reached over 5,000 of our customers. That was 90 more seminars than the preceding year, reaching 3,800 more participants. This newsletter is also a new education tool for our customers. We processed 75,858 new taxpayer applications last year - an increase of over 25,000 from the preceding year - and we dramatically cut the turnaround time on those applications. We brought up numerous electronic filing applications, including sales tax, consumer use tax, and business registration applications. Finally, we have also put a number of checks in place to monitor error issues.

We certainly have many areas where we are continuing to improve our services and procedures. For those of you who take the time to tell me about a pleasant - or an unpleasant - interaction with the department - or for those who volunteer a suggestion, I want to say thank you. We have received and incorporated many suggestions from our customers. Also, if you would like to see a topic covered in an upcoming newsletter, please let us know.

## Contact Us

- Taxpayer hot line: Statewide toll-free (800) 342-1003; Nashville-area and out-of-state callers call (615) 253-0600.
- Online tax help by e-mailing [TN.Revenue@state.tn.us](mailto:TN.Revenue@state.tn.us).
- Streamlined Sales Tax hot line: In Tennessee, call (877) 250-2299. In Nashville and outside Tennessee, call (615) 253-0752.
- Streamlined Sales Tax online assistance by e-mailing [Streamlined.Salestax.QandA@state.tn.us](mailto:Streamlined.Salestax.QandA@state.tn.us).
- Tax practitioner hot line: Statewide toll-free (800) 387-8395; Nashville-area and out-of-state callers should call (615) 253-0700.
- E-mail updates: We distribute timely information about new important notices, announcements and other news of interest. Visit our Web site, [www.Tennessee.gov/revenue](http://www.Tennessee.gov/revenue), to subscribe to Revenue-News or lists dedicated to county clerks and city officials.
- Tax fraud hot line: To report tax fraud, call (800) FRAUDTX (372-8389).

## Tax Rulings

Full texts of these recently posted redacted tax rulings are available on our Web site under "Tax Rulings." Tax rulings are not binding on the department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of departmental policy.

### Sales and Use Tax

**Food and Food Ingredients** – #04-16 – June 2004

**Medical Equipment and Supplies – Items Billed through TennCare** – #04-13 – April 2004

**Store Supplies – Use in Retail Outlets/Subsidiaries** – #04-07 – February 2004

**Hotel Rooms – Deposits, Early Departure Fees** – #04-04 – February 2004

**Industrial Machinery Exemption – Copy Machines** – #04-06 – January 2004

**Digital Identification Numbers** – #04-03 – January 2004

**Internet – Fee to Access Software** – #03-12 – December 2003

### Franchise and Excise Taxes

**Apportionment – Drop Shipments** – #04-12 – April 2004

**Limited Liability Company and Holding Subsidiary** – #04-01 – January 2004

### Business Tax

**Temporary Labor Service** – #04-15 – June 2004

#04-10 – March 2004

**Are you a registered taxpayer? If YES, we need your tax contact's e-mail address, so we can e-mail information in the future.** Call toll-free (800) 342-1003; Nashville-area and out-of-state callers, dial (615) 253-0600.



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